

**Energy Marketers 2000**  
**National Energy Marketers Association**

**William L. Massey**  
**Commissioner**  
**Federal Energy Regulatory Commission**

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I. Introductory Remarks

Good afternoon. I appreciate the opportunity to address this conference. We are in the midst of an important phase of the transition of the electric power industry toward relying on competitive market solutions. The marketing community has been one of the forces of change that has pushed the transition along, and has been a voice for good policy choices along the transition road. Your voice will continue to be important as we progress. After reviewing NEMA's legislative and policy recommendations, I realized that we are in agreement almost without exception. You support an aggressive restructuring policy at the federal level, and so do I. That's why I've looked forward to sharing my views on policy development with you and to getting your feedback.

I note that a theme of one of this afternoon's panels is developing competitive liquid wholesale markets. You should know that this is my overarching policy objective for both natural gas and electricity. I would like to discuss what I see as the challenges ahead for FERC in accomplishing this objective. Although I will focus primarily on FERC efforts to promote electric markets, I will also make a few comments about natural gas markets.

II. The Role of Regulators in the New World

Today's wholesale electricity and natural gas markets are increasingly competitive, due in no small part to FERC policies that have pried open the interstate delivery systems. The gas and electric industries are strikingly similar in the regulatory challenges they pose. In both industries, the basic commodities can

be traded in competitive wholesale markets. They are not characterized by natural monopoly. The Commission's philosophy now is that natural gas and electricity can best be supplied through competitive markets; that competition can discipline commodity prices better than regulation; and that competition unleashes the creative energies of market participants to develop the innovative products and services their customers want.

While this is true, deregulation of the energy commodity does not mean that regulators can simply pack up their bags and go home. Occasionally at conferences, someone will say, "Regulators should just get out of the way and let the markets work." I puzzle over this. There is no competition and there are no markets unless the commodity can be delivered over an open and nondiscriminatory network of pipelines and wires. Markets do not simply spring magically and effortlessly into existence after 100 years of monopoly regulation just because regulators get out of the way. Markets must be nourished by regulatory policies that first pry the transportation networks open, and then keep them open. Gas and electricity transportation occurs over highly integrated interstate networks that still exhibit natural monopoly characteristics and thus must be appropriately regulated. Access to these networks and efficient operation of the networks are critical to robust commodity markets, but present complex technical and policy issues. Consequently, a good deal of our regulatory attention is now focused on the transportation network.

### III. RTO Development

Turning to the interstate transportation network for electricity, I believe the widespread development of Regional Transmission Organizations is absolutely critical to competitive markets. The issue of RTO formation is constantly on my mind. Non-discriminatory access to an efficiently operated, reliable, regional transmission grid is essential if market decisions are to be based on straightforward economics and not dictated by strategic manipulation, a restricted operational scope and a feudal system of pricing. The text of Order No. 2000 shared these basic goals and the importance of RTOs to attaining them.

A well-designed RTO can take a real bite out of vertical market power by separating the control of transmission from merchant functions. This is a first principle. RTOs also hold promise for resolving a number of grid management

problems and eliminating balkanization through market-based congestion management, efficient pricing that will expand the scope of power markets, and a credible calculation of Available Transmission Capability that will facilitate trade.

RTOs will also make a critical contribution to grid reliability. Under Order 2000, a single RTO will be responsible for the reliability of the grid over a large area, with centralized responsibility for congestion management, system emergencies, restorations, and scheduling generation and transmission outages.

RTOs should also improve the process for getting new transmission facilities sited. RTOs will be responsible for planning transmission expansions and coordinating such efforts with the appropriate state authorities.

RTOs will also promote reliability by attracting new generation participants. An RTO will provide one-stop shopping for new generators over a broad market area, and provide fair tariff administration and interconnection evaluation. The current scattered administration of the grid, and the perception that the rules of the road are not applied fairly, may be keeping some players, and needed resources, out of the market. RTOs will facilitate their entry.

For all of these reasons, RTO will indeed be beneficial and their formation is essential. Order No. 2000 expressed a sense of urgency in attaining these benefits, and required all public utility transmission owners to file this October their plans for RTO development. In an effort to facilitate RTO formation, the order established a collaborative process starting with a series of five Commission-sponsored regional meetings. Those meetings have now been completed. So where are we now? Have the meetings been useful?

In general, the feedback I've gotten has been encouraging. I think the regional meetings accomplished the following. First, they got market participants together to discuss issues. In some regions, dialogues among participants have been initiated or renewed. For example, in the Midwest I understand that discussions between the Midwest ISO and the Southwest Power Pool have been rekindled. Second, the conferences identified issues and impediments to RTO formation in the regions. In some cases participants were surprised to learn that their differences were not as great as first thought. This is encouraging. And third, in all of the

regions, there are commitments to follow-on meetings and processes for RTO formation.

While all of this is modestly encouraging, I am nevertheless concerned. I championed a more direct approach for FERC to get RTOs formed. It is a source of frustration to me that the Commission chose a program that professes to be voluntary. Order No. 2000 is superb except for the punchline. There is no forcing mechanism to ensure good RTOs filings.

While the regional conferences resulted in a lot of discussion, many market participants are concerned that's all that will happen. Just talk, no action. Market participants are concerned that some October filings may say, "Gee, I'm sorry, but the dog ate my RTO proposal." I hope not. I am concerned that the RTO filings the Commission receives will be something less than concrete proposals that meet Order No. 2000 standards. This would indeed be unfortunate. Good RTOs are needed now.

So I urge you in the marketer community to continue to press for RTO formation. The Commission has turned this job over to the industry. This means you at least in part. Please help us ensure that it gets done expeditiously.

We almost certainly will be asked to shave the standards set out in Order No. 2000. Given the voluntary approach to RTO formation, some transmission providers will surely hold out from joining an RTO unless some of the standards are weakened. I expect to receive RTO proposals that do not measure up in terms of independence, scope and configuration, or operational authority. I have already heard from some market participants that the Commission's voluntary approach will result in "lowest common denominator" RTO proposals.

Order No. 2000 set out good minimum standards, ones that I view as absolutely necessary to ensure that RTOs will attain all of the benefits of grid regionalization. These standards already reflect political compromises. They should not be further compromised in our zeal to accept voluntary RTO filings.

#### IV. Interconnection Policy

In addition to RTO development, there is another challenge to assuring that electricity markets are open and competitive. Marketers and generators have described barriers to interconnection, such as a protracted, gamed process, or a requirement that generators purchase long term transmission service as a precondition to securing interconnection. Generators and some utilities tell us that negotiating individual interconnection agreements is time consuming, burdensome and should be unnecessary.

In our recent Tennessee Power order, the Commission clarified our interconnection policy in three positive ways. First, we declared that interconnection is an element of transmission service required to be provided under our pro forma tariff and that generators have the right to request the interconnection component separately from the delivery component. This is important because new merchant plants may not have long term sales contracts and thus may not at the outset need long term transmission service. In other words, we unbundled "access to the grid" from "access across the grid."

Second, the Commission declared that, once secured, the interconnection component of transmission service conveys a right to inject power into the grid at the point of interconnection, consistent with the parameters of the service agreement.

And third, the Commission clarified that the protections afforded by the pro forma tariff provisions apply to interconnection. These include procedures for arranging service, time limits, customer responsibilities, study procedures, compensation for new facilities, and service agreements. These reasonable and time-limited procedures will eliminate interconnection legerdemain.

But I would urge the industry and the Commission to take an additional step and develop a standard agreement that sets out the steps and technical standards required for securing an interconnection. Standardizing interconnection agreements will streamline and cut down "negotiating time" to the benefit of both transmission provider and generator.

Moreover, I would urge the industry and the Commission to move aggressively toward an industry-wide standard interconnection agreement that would at least establish minimum acceptable terms and conditions. Our pro forma transmission tariff under Order No. 888 standardized transmission service across market areas and provided a floor for good service. It strikes me as logical that a "pro forma interconnection agreement" would be similarly beneficial.

While I'm on the subject, the Commission has just announced a very pro-competitive policy for interconnection to the natural gas transportation network as well. In a case involving Panhandle, the Commission recently said that the right to interconnect was available under a five part test. Essentially, if the party seeking to interconnect pays for the interconnection and it is operationally feasible, the pipeline must interconnect if it does not degrade service to existing customers.

A by product of this new policy may be the development of more pipeline market hubs where gas and capacity can be traded. There are now in excess of 40 such hubs in the U.S. market, and they facilitate market liquidity.

## V. Market Operations

Now let me turn to market operations. Ensuring fair access to the grid and efficient operation of a regional grid is going to present mighty challenges to the Commission in the next few years. But that is not the full job. There are yet more challenges to FERC along the road to liquid, competitive electricity markets.

One of those challenges is developing effective trading institutions and practices. There are three basic attributes to good trading practices. One of them is organization. Markets can vary in the degree to which they are organized and still provide a fairly effective trading medium, but common terms of trade, such as standard products and contract conditions are important. A second attribute of an efficient trading regime is transparency of price. Players must know the prices at which transactions occur in order to adjust their operations. And the third basic attribute is appropriate hedging instruments. Hedging instruments, such as futures contracts, are critical to industries such as gas and electricity that exhibit price volatility during certain periods.

While good trading institutions are important, the FERC is primarily relying on private industry to develop them, and RTOs will provide an excellent venue for organized trade.

I also believe that markets will require some degree of monitoring, either by the Commission or by other neutral entities. We must ensure that market power has been weeded out. The structure of these new markets, and their trading institutions, cannot be ignored if competition is to flourish. Experience is fast teaching us that the complexity of electricity network operation lends itself to gaming, such as creating artificial congestion. And the complex bidding rules required for some of the short term markets may also be gamed to create market power. Monitoring will help ensure against these abuses. And disputes among market participants will still need to be sorted out, sometimes in a public forum.

Thus, a regulatory presence is still needed to help instill a sense of trust and legitimacy in the markets that can be respected by traders and investors. My presumption is that FERC, an institution with a broad interstate mandate, is uniquely qualified to serve that role.

## VI. Merger Policy

Now let me turn to merger policy. We are seeing unprecedented industry consolidation. Pipeline conglomerates are being formed, traditional electric utilities are merging with each other, utilities are buying marketers and independent power producers, and vice versa. FERC has jurisdiction over mergers involving electric assets, and we are under increasing pressure to process mergers quickly to allow for timely business decisions. But we must balance that pressure with tough but fair analyses of the competitive effects, both horizontal and vertical, of proposed mergers. While mergers can produce efficiencies, we must cast a wary eye to ensure they do not choke off the competition that is just now beginning to take hold in electricity markets.

How might a merger choke competition? First, by consolidating ownership of generation assets in a market, a merger may create both the ability and incentive for the newly merged entity to withhold generation and drive up prices. This is classic horizontal market power. Secondly, a merger may exacerbate vertical market power – that is, the ability and incentive of the newly merged firm to use its control over

one line of business to favor another line of business. In the AEP-CSW merger, the concern was that the merger created an incentive for the merged firm to dispatch generation in a way that would create transmission bottlenecks and frustrate competition in wholesale generation markets. In the merger of CNG, a natural gas pipeline, with Dominion Resources, an electric utility, the vertical market power concern was that the merged firm would have an incentive to operate its pipeline assets to discriminate against the gas-fired generation owned by others, thereby favoring its own generation. Unacceptable levels of generation concentration and vertical market power must be effectively mitigated for the merger to go forward.

The Commission does not question the wisdom of a merger from a business perspective. We make no judgment whether a merger will enhance shareholder value. We focus almost exclusively on whether a proposed merger is inconsistent with our broader pro-competitive goals.

I believe that this is important work. At the risk of repetition, let me underscore my view that one cannot claim to believe in competition and remain agnostic about market structure. And mergers can dramatically change the structure of energy markets. We must be vigilant in this area.

## VII. Legislation

Finally, I would like to turn to the legislative arena. I've been discussing the challenges that I see ahead for the Commission in establishing open, competitive, liquid electricity markets. The likelihood of success in meeting these challenges could be increased by some of the legislation that's being debated now.

The first major area is transmission jurisdiction. One positive move would be to place transmission service offered by public power, rural electric cooperatives, and Federal utilities under FERC open access rules. This would be a key step toward seamless open access.

I would also recommend that all uses of the interstate transmission grid be placed under one set of rules, the FERC open access tariff. The jurisdictional split over transmission between federal and state regulators just will not work long term. This split is a balkanizing impediment to vibrant competition. Power markets are regional, whether wholesale or retail, and do not respect state boundaries. All



interstate grid users should be subject to the same rules. Different transmission rules set by individual states will create seams between states, result in discriminatory access in favor of in-state load, and a sharp splintering of the markets that are now developing.

Regarding RTOs, Congress should give the Commission the clear authority to form and shape them. Leaving the decision to join RTOs entirely to the discretion of transmission owners is not sound policy. By allowing a "hold out" strategy, transmission owners will also be able to unduly influence the organizational form of an RTO and to insist on a geographic scope and configuration that would result in price or access. The Commission must have the explicit power to facilitate pro-market RTO configurations.

Finally, the Commission should be given direct and express authority to remedy market power. As we strive to move toward competitive markets and light-handed regulation, the Commission's ability to remedy market power is increasingly important. Yet the Commission has only indirect conditioning authority to do so. Market power is likely to exist in the electric industry for a while. It is unreasonable to expect an industry that has operated under a heavily regulated monopoly structure for 100 years suddenly to shed all pockets of market power.

I note that NEMA supports the legislative Principles of the Electricity Restructuring Stakeholders. I believe those principles provide an excellent framework for legislation and are generally consistent with my views. I applaud NEMA for signing on to these principles.

#### VIII. Concluding Remarks

In conclusion, regulators have a clear role in promoting markets. We must ensure an open, efficient and nondiscriminatory delivery system that operates under one set of rules. We must pay attention to market power. We must insist on a pro-competitive market structure. Let's tackle these problems together.

Thank you.